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CHARLES ELMORE

IN THE

Supreme Court of the United States

October Term, 1948.

No. [redacted]346

~~HYMAN Y. JOSEPHS~~,

ESTATE OF HYMAN Y. JOSEPHS, Deceased, ARTHUR C. JOSEPHS, Executor, Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION FOR WRIT OF CERTIORARI AND BRIEF IN SUPPORT THEREOF.

FLOYD F. TOOMEY,
1200 18th Street N. W.,
Washington 6, D. C.,
Attorney for Petitioner.

H. A. DANCER,
1000 Alworth Building,
Duluth, Minnesota,
Of Counsel.

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October Term, 1948.

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~~HYMAN Y. JOSEPHS,~~

ESTATE OF HYMAN Y. JOSEPHS, Deceased, Petitioner,
ARTHUR C. JOSEPHS, Executor

~~against~~

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The above named Petitioner prays that a writ of certiorari be issued to the United States Circuit Court of Appeals for the Eighth Circuit to review a judgment of that Court rendered in the above entitled cause on May 20, 1948 (R. 70), reversing a decision of The Tax Court of the United States which had found that there was no deficiency in the federal income tax of the Petitioner for the calendar year 1941 (R. 11). The Tax Court had approved the deduction under Section 23 (a) (2) of the Internal Revenue Code of certain expenses incurred by Petitioner in the settlement of pending litigation, together with attorneys fees incurred and paid for services in connection with such litigation, and the question is whether the Circuit Court of Appeals was in error in reversing that decision.

JURISDICTION

The jurisdiction of this Court is invoked under the provisions of Section 240 (a) of the Judicial Code as amended, being now Title 28 U. S. C. A. Section 347 (a).

THE OPINIONS OF THE COURTS BELOW

The opinion of The Tax Court is reported in 8 T. C. 583. The opinion of the Circuit Court of Appeals is reported in 168 Fed. (2) 233.

SUMMARY STATEMENT OF THE MATTER INVOLVED

For several years ending in 1941, the taxpayer Josephs was one of the administrators of the estate of Ignatz Freimuth, deceased, late of Duluth, Minnesota. Late in 1939 five of decedent's nine children and heirs filed in Probate Court their complaint of the alleged manner in which the estate was being handled and asked for an accounting.

The administrators shortly thereafter filed their final account, to which the objecting heirs filed objections, praying that the administrators be surcharged with large amounts. After trial of the issues involved the Probate Court allowed said final account with minor exceptions, ordering no surcharge against petitioner. The objecting heirs appealed from that order of the Probate Court to the District Court of Minnesota.

At about the same time the said objecting heirs commenced an independent suit in their own behalf against said administrators in said District Court praying for upwards of $300,000 damages. The District Court sustained defendants' demurrer to the complaint of the objecting heirs and said heirs appealed from that decision to the Supreme Court of Minnesota.

With long litigation and delay in closing the estate in sight, all parties to the litigation thereupon entered into a comprehensive agreement dated July 21, 1941, for the settlement of all pending litigation, the disposition of the estate and the termination of the probate proceedings.

By that agreement, without any adjudication, finding, or admission of malfeasance or liability, and with the consent of all other heirs, it was agreed: That the taxpayer would pay to the objecting heirs $10,000; that his co-defendant and co-administrator, David C. Freimuth, son of decedent, would pay them $5,000; that the pending appeals would be dismissed on the merits; that the property of the estate be disposed of as in said agreement provided; that the probate proceedings be terminated and the administrators be released from all further obligation or liability. All parties to the agreement joined therein in asking the courts involved to make such orders as might be necessary or desirable to consummate the agreement. The agreement was promptly carried out.

The taxpayer in his federal income tax return for 1941 deducted from his gross income the $10,000 so paid by him together with $1,500 attorneys fees incurred and paid in connection with such litigation, as either ordinary and necessary expenses in carrying on a trade or business or as a non-business expense for the production of income. The Commissioner of Internal Revenue disallowed such deduction and determined a deficiency in petitioner's income tax of $6,887.23. The Tax Court of the United States found that the payments were made for the production of income within the provisions of Section 23 (a) (2) of the Internal Revenue Code and reversed the Commissioner. The Circuit Court of Appeals of the Eighth Circuit, by a two to one decision on May 20, 1948, reversed The Tax Court and reestablished the deficiency. That court held that such expenditures were

not "ordinary and necessary expenses" of a fiduciary within the meaning of Section 23 (a) (2) and that they were not incurred or paid for the production of income within the meaning of that subdivision.

As a part of the settlement and prior to the payment of the $11,500.00, the petitioner waived his right to compensation for his services as administrator and, consequently, procured no income from that enterprise.

THE STATUTE INVOLVED

The statute involved is Section 121 of the Revenue Act of 1942, which amended Section 23 of the code, providing for deductions from gross income to arrive at taxable income, by adding a new subdivision (a) (2) providing for additional non-business deductions and making such amendment applicable to taxable years beginning after December 31, ~~1948~~. /938

The relevant portions of said Section 23 as amended in 1942 now read as follows:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *

(2) *Non-trade or Non-business Expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

STATEMENT OF FACTS

The Tax Court made and filed clear and not too lengthy findings of fact as found beginning on page 12 of the record. The Court will wish to read those findings in full. We think they are all material and that the Court would not desire us to reprint them all here. We, therefore, respectfully incorporate those findings herein by reference thereto as our statement of facts.

QUESTIONS INVOLVED

The ultimate question is whether the taxpayer Josephs is entitled to a deduction from his 1941 gross income of $10,000 paid in settlement of pending litigation and $1,500 paid for attorneys services therein, in order that he might be released from possible liability as administrator of the Estate of I. Freimuth, Deceased, and that said estate might be promptly closed and the property distributed without further delay.

The answer to the foregoing question will depend upon the answer to one or more important questions of Federal law of general applicability, as follows:

1. Whether within the meaning of Sections 23 (a) (2) any item of expense reasonable in amount incurred and paid in a non-business enterprise or activity for the production of income is deductible if it is directly connected with or proximately results from the conduct of the enterprise or activity as a whole, or whether such expense is deductible *only* if it be necessarily incurred and paid in order that any income may be produced at all, this latter alternative having been expressed by the Court of Appeals in the Heide case, 165 Fed. (2d) 699, and followed by the Circuit Court of Appeals in this case as follows: "The expense so deducted * * * should result from conditions which stand in the path of his producing the income at all."

2. Whether within the meaning of said Section 23 (a) (2) the amounts paid by an administrator of an estate in settlement of litigation pending against him for alleged malfeasance in the performance of his duties and for attorneys' fees incurred for services in such litigation are "ordinary and necessary expenses" of such administrator personally, his motive in accepting the trust having been the production of income for himself.

REASONS RELIED ON FOR THE WRIT

The Circuit Court of Appeals has decided important questions of Federal Law which have not been, but should be, settled by this Court. That Court has also decided Federal questions in a way we believe and allege to be in conflict with applicable and controlling decisions of this Court, to-wit: *Bingham's Trust v. Commissioner of Internal Revenue,* 325 U. S. 365, 65 Supreme Court Reporter 1232; *Commissioner v. Heininger,* 320 U. S. 467; *Dobson v. Commissioner,* 320 U. S. 489.

More specifically:

Prior to the amendment of Section 23 of the Code in 1942, it was the settled law that any taxpayer carrying on a business might deduct litigation and other expenses when directly connected with or proximately resulting from the enterprise. During that same period, a taxpayer carrying on a non-business enterprise or activity for the production of income, or engaged in managing or maintaining property held for the production of income, could not deduct such expenses, or any expenses which did not directly contribute to the production of income. Section 23 (a) (2) was added to the Code in 1942 to correct that inequity.

In the Bingham's Trust case, supra, which involved the management and maintenance of property held for the collection of income, the Court discussed at length the meaning of Section 23 (a) (2) and held that by analogy

to the business expense deduction provision contained in Section 23 (a) (1) the taxpayer engaged in the enterprise of managing or maintaining property held for the production of income "may deduct litigation expenses when they are directly connected with or proximately result from the enterprise * * *."

In view of the apparent purpose of the Congress to eliminate certain distinctions taxwise between the three classes of taxpayers falling within Section 23 (a) (1) and 23 (a) (2), and considering itself bound by the language of the Court in the Bingham's Trust case, The Tax Court in this case treated Mr. Josephs' activity for the production of income, which he had carried on for several years, as an entity, and held that the settlement and litigation expenses incurred by him arose directly and proximately out of the carrying on of the enterprise itself and that they were deductible from the taxpayer's other gross income.

The Circuit Court of Appeals reversed The Tax Court, holding that such a non-business enterprise for the production of income can not be treated as an entity and that a taxpayer carrying on such enterprise can deduct only such expenses as are actually designed, paid for, and necessary to the production of income, holding that it is not sufficient that such expense bear a reasonable and proximate relation or arise directly and proximately out of the carrying on of the enterprise.

The Court of Appeals held that the expenses of the taxpayer in this case were not such ordinary and necessary expenses resulting from the activity of a fiduciary as are deductible under Section 23 (a) (2), although many cases have already held that such settlement and litigation expenses are deductible as such when incurred by a professional administrator, such as a trust company which makes it a part of its regular business to act as executor, administrator, or other trustee. The effect of

the holding is that a casual administrator is held to as high degree of care as a professional administrator, but still does not have the same right to deduct expenses as a professional administrator, notwithstanding the provision of Section 23 (a) (2). Cases sustaining these statements will be cited in our brief in support of this petition. We contend that the Bingham's Trust case and the Heininger case, supra, are controlling in this case. Great numbers of Federal income taxpayers are undoubtedly directly affected by the meaning of Section 23 (a) (2) with respect to the questions raised in this case, and we respectfully submit that all these questions should be clearly and definitely settled by this Court.

FLOYD F. TOOMEY,
1200 18th Street N. W.,
Washington 6, D. C.,
Attorney for Petitioner.

H. A. DANCER,
1000 Alworth Building,
Duluth, Minnesota,
Of Counsel.

BRIEF IN SUPPORT OF PETITION

Questions Presented, Statement of Case, Etc.

Statements of the case and of the questions and statutes involved and our statement of facts will be found or referred to in the petition.

Specifications of Error and Summary of Argument.

1. The Circuit Court of Appeals erred in holding that a non-business enterprise for the production of income may not be treated as an entity under the provisions of Section 23 (a) (2), and that ordinary and necessary expenses arising directly and proximately out of such activity are not deductible.

2. The Circuit Court of Appeals erred in holding that only those particular items of expense incurred and paid in such enterprise are deductible which are necessary to the production of income—such as are incurred and paid for the removal of obstacles standing in the way of any income at all.

3. The Circuit Court of Appeals erred in holding that expenses incurred and paid by Mr. Josephs in settling litigation against him for alleged malfeasance in office and for attorneys fees in carrying on such litigation were not ordinary and necessary expenses within the meaning of Section 23 (a) (2).

4. The Circuit Court of Appeals erred in reversing The Tax Court on questions which are not reviewable.

Summary of Argument.

The construction placed on Section 23 (a) (2) by the Circuit Court of Appeals is contrary to that intended by Congress. As so construed, said subdivision (2) will not accomplish the purpose for which it was enacted. It

would have no effect at all upon the rights of a taxpayer engaged in a non-business enterprise for the production of income. The expenses incurred by the taxpayer Josephs were ordinary and necessary expenses within the meaning of Section 23 (a) (1) of the Code, and were ordinary and necessary expenses within the meaning of identically the same language in Section 23 (a) (2). Whether the expenses incurred and paid by Mr. Josephs were ordinary and necessary is a question to be determined by The Tax Court, and under the Dobson case, supra, is not reviewable.

We will argue all of the above assignments of error.

ARGUMENT

Assignment of Error No. 1.

The Tax Court found specifically that petitioner Josephs, in acting as administrator, had engaged in an enterprise for the production of income; that he would not have accepted the position except for the hope and expectation of receiving compensation for his services. Those findings are conclusive.

The Tax Court treated that enterprise for the production of income as an entity, the same as if it had constituted a business on the part of Mr. Josephs, and it held that the expenses incurred and paid by him were directly connected with the enterprise or arose directly and proximately out of the conduct of that enterprise within the doctrine of *Kornhauser v. United States*, 276 U. S. 145, and therefore approved the deduction. ~~*Julius A. Heide*, 8 Tax Court 314.~~ Josephs v Comm 8 T.C 583

The Circuit Court of Appeals, on the contrary, held that Mr. Josephs' enterprise for the production of income can not be treated as an entity, and that no item of expense incurred by him in carrying on such enterprise is deductible unless it was designed, and necessary, for

the production of income. That Court in effect ignored the enterprise as a whole, and holds that the deductibility of each individual item of expense is subject to that test of design and necessity.

We agree with The Tax Court, and it is our contention that any expenses directly connected with or, as otherwise stated, proximately resulting from an enterprise carried on for the production of income is deductible, whether the taxpayer be in business or not.

The Court will, of course, endeavor to ascertain the purpose and intent of the Congress and to construe that part of Section 23 (a) (2) involved herein as will effect that purpose, if such construction can be adopted without doing violence to the language of the statute itself.

A taxpayer makes only one income tax return, and his entire net income from all sources and enterprises is treated as one income and taxed in applicable brackets. He is not permitted to make an income tax return for each enterprise on which he has been engaged and then pay only the sum total of the tax on such several smaller incomes in lower tax brackets.

If the taxpayer conducts a business and a non-business enterprise for the production of income, and makes a profit in both, the profits are treated as part of one income and he is taxed accordingly. It would therefore be most illogical and unfair if he lost money through losses and expenses in the non-business enterprise and should not be permitted to deduct such losses and expenses from his total net income.

Prior to the amendment of Section 23 of the Revenue Code in 1942 there were such inequities and other gross inequities existing between different classes of taxpayer. The case of *Higgins v. Commissioner,* 312 U. S. 714, brought sharply to the attention of the public and the Congress the law that while a man, in carrying on a business, might deduct all expenses arising directly and

proximately in the conduct of that enterprise, nevertheless a taxpayer who managed and maintained property for the production of income could not deduct any expenses of managing or maintaining that property, even though the property itself produced taxable income. Concededly, as a result of that holding (*Reinhold v. Commissioner,* 144 Fed. (2d) 390), the new subdivision (a) (2) was added to Section 23 in 1942. The purpose of this statute is well expressed in House Report No. 2333, 77th Congress, First Session Cumulative Bulletin 1942-2, page 410 as follows:

> "The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, non-trade or non-business expenses are not deductible, although non-trade or non-business income is fully subject to tax. The bill *corrects this inequity* by allowing the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income, or in connection with property held for the production of income, it is allowable." (All italics herein is ours.)

In view of this explanation of the purpose and effect of the Act we must assume it to have been the intent of the Congress to correct the inequity which had theretofore existed between a man carrying on a business for the production of income, on the one hand, and a man carrying on a non-business enterprise for the same purpose or managing and maintaining property held for the production of income.

In the Bingham's Trust case the Circuit Court of Appeals of the Second Circuit had held that various expenses incurred in the management and distribution of

a trust estate were not deductible. There were so many of such expense items of such varied character that the Court evidently felt called upon to make a comprehensive statement of the meaning and effect of Section 23 (a) (2) as interpreted by it. This it proceeded to do, and it then applied such interpretation in deciding whether the various items of expense involved in the case were deductible. In its opinion the Court used the language:

> "Section 23 (a) (2) is comparable and in pari materia with Section 23 (a) (1) authorizing the deduction of business or trade expenses. Such expenses need not relate directly to the production of income for the business. *It is enough that the expense, if ordinary and necessary, is directly connected with or proximately results from the conduct of the business* * * * (citing cases). The effect of Section 23 (a) (2) was to provide for a class of non-business deductions co-extensive with the business deductions allowed by Section 23 (a) (1), except for the fact that, since they were not incurred in connection with the business, the section made it necessary that it be incurred for the production of income or in the management or conservation of property held for the production of income."

The opinion of the Court further proceeds:

> "Since there is no requirement that business expenses be for the production of income, there is no reason for that requirement in the case of like expenses of managing a trust, so long as they are in connection with the management of property which is held for the production of income. Section 23 (a) (2) thus treats the trust as an entity for producing income comparable to a business enterprise and like Section 23 (a) (1) permits deductions of management expenses of the trust even though the particular expense was not an expense directly producing income."

In carrying the doctrine above stated to their logical conclusion the Court might well have said, and we think

it would have said, if such expenses were involved there as are involved in this case, that since there is no requirement that business expenses be for the production of income, there is no reason for that requirement in the case of like expenses of managing a trust or conducting a non-business activity for the production of income so long as they are in connection with the management of property which is held for the production of income or arise directly and proximately out of such activity for the production of income. Section 23 (a) (2) thus treats the trust and the activity for the production of income as entities comparable to a business enterprise, and like Section 23 (a) (1) permits deduction of such expenses even though not expenses directly producing income.

That such non-business enterprise for the production of income should be treated as an entity is particularly true in a case like this where a taxpayer enters upon such enterprise and carries it on over a period of years.

The House Report, supra, supports the contention of The Tax Court that the enterprise upon which Mr. Josephs was engaged is to be treated as an entity. Referring to subdivision (a) (2), it was stated in that report:

> "For an expense to be deductible under this section it must have been incurred either (1) for the production or collection of income or (2) for the management, conservation or maintenance of the property held for the production of income. Ordinary and necessary expenses so paid or incurred *are deductible* under Section 23 (a) (2), *even though they are not paid or incurred for the production or collection of income* of the taxable year. * * * The term 'income' for this purpose comprehends not merely income of the taxable year, but also income which a taxpayer has realized in a prior taxable year or may realize in subsequent taxable years."

An expense in the current year for income already produced in a prior year can not be said to have been incurred "for" the production of income, except upon the theory that the statute refers to an enterprise or activity for the production of income as a whole rather than to any single items of expense considered alone.

This construction is further supported by what the report says is not covered by Section 23 (a) (2):

> "The expenses, however, *of carrying on a transaction* which does not constitute a trade or business of the taxpayer, and is not carried on for the production of income or for the management, investments or maintenance of the property, but which is carried on primarily as a sport, hobby or recreation, are not allowable as non-trade or non-business expenses."

This meaning is further emphasized by a statement in the Senate Report on the Act of 1942, which does not appear in the House Report, although the two reports are almost identical:

> "Expenses incurred in managing or conserving property held for investment may be deductible under this provision, even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held to minimize a loss with respect thereto." Senate Report No. 1631, 77th Cong., 2nd Session, pages 87-88.

An item of expense in maintaining or managing a property no longer actually held for the production of income, but on the contrary held only to minimize a loss, can not be held to be an expense of managing or maintaining property held "for" the production of income within the meaning of Section 23 (a) (2), unless and except under the construction of said subdivision to refer to expenses of the enterprise as a whole instead of individual items of expense.

The above quotation from the Senate Report applies exactly to the Josephs enterprise. He carried it on for several years for the production of income but was finally forced to abandon that hope and to incur a total loss of $11,500 in order to minimize what might have been a loss of over $300,000 at the hands of some prejudiced jury or through the error of some court.

In view of the stated purpose and effect of the Act it is impossible for us to believe that the Congress intended such enterprise as a whole to be ignored and only individual items considered. The purpose of the Congress to correct the inequities between the three classes of taxpayers covered by Section 23 (a) (1) and 23 (a) (2), can be accomplished only by treating such enterprise for the production of income as an entity, the same as this court in the Bingham's Trust case treated the management of property held for the production of income and as a business enterprise has always been treated.

In any event, as we shall argue under Assignment of Error No. 4, that the determination of The Tax Court to treat the entire activity of Mr. Josephs for the production of income as an entity, instead of treating the two expense items here under consideration alone by themselves, is conclusive and binding and not subject to review by the regular courts.

Under the Ruling of the Circuit Court of Appeals the Inequities Which Congress Undertook to Correct Would Not Be Corrected.

It seems very clear that under the construction by the Circuit Court of Appeals the inequities between the three classes of taxpayers covered by said subdivision (a) (1) and (a) (2) would not be corrected. The taxpayer who carries on a non-business enterprise for the production of income would be in a position far inferior to that of

the man who carries on a business or the man who manages property for the production of income. An example which would arise out of circumstances commonly existing will illustrate this fact: It is a most common practice for a testator to provide by his will for two executors, one a Trust Company and the other an individual. Acting as executor or other trustee is a part of the regular business of trust companies. It is only a non-business, casual enterprise for the production of income on the part of most individuals. The result would be that all of the litigation expenses of the trust company in resisting a claim of malfeasance in the performance of its duties as administrator, or in compromising such claim, would be deductible by the trust company from its gross income, but none of such like expenses incurred and paid by the individual executor would be deductible. There could be no escape from such grossly inequitable result under the holding of the Court of Appeals.

Again, a Kansas farmer, as a non-business enterprise for the production of income, may start to drill an oil well on his farm. As long as he hopes to strike a gusher and is making expenditures which are necessary in carrying on the enterprise, then such expenses are deductible, but after he abandons hope of success, then no expenses are deductible, and all the cost of salvaging the drills, pulling the casings, and otherwise making his loss as little as possible would fall on him alone without any tax relief. On the contrary, if the well were being drilled by a man making well drilling his business, all such salvage expenses would be deductible. Again we say, there could be no escape from such inequitable result under the holding of the Circuit Court of Appeals. Such illustrations could be multiplied almost without limit.

It must be conceded that if the holding of the Circuit Court of Appeals is to prevail, then the Congress has miserably failed in its efforts to correct such inequities.

Such failure the Court may and should prevent by following the decision of The Tax Court.

Assignment No. 2.

The Court of Appeals Erred in Holding That Only Those Items of Expense Are Deductible Which Are Necessary, or Contribute, to the Production of Income.

The Court of Appeals in this case cites approvingly and evidently follows the holding of the Circuit Court of Appeals in the case of *Commissioner v. Heide,* 105 Fed. (2d) 699. That Court held in that case that expense incurred, to be deductible under the first part of subdivision (a) (2) must arise under circumstances such that without such expenditures there would be no income at all. In other words, the Court holds that the burden is upon the taxpayer to show that the expense is necessary for the production of income.

One fallacy of this doctrine is that the words of the statute do not require that an expense be necessary for the production or income, or contribute to the production of income. All that Section 23 (a) (2) requires, even under the most narrow construction, is that the expense be incurred and paid "for" the production of income. The word "for" here means motive. If a taxpayer's motive in incurring and making an expense expenditure is production of income, the requirements of the statute are satisfied. Faultless judgment on the part of the taxpayer as to the necessity for, or the result of, such expense is not required.

If the "necessary" test be applied to each item of expense to determine its deductibility, then if no income be produced the taxpayer would be required to demonstrate that if income had been produced the expense in question would have been necessary to such production of income and would have contributed to it. This would be a require-

ment generally impossible to comply with. The practical result would be that the holding of the Circuit Court of Appeals be sustained in this respect, that only such expenses are deductible that actually contribute to the production of income.

Here again an unsurpassable obstacle would arise. Many enterprises for the production of income extend over all or parts of two or more taxable years. It is not known until the enterprise is actually completed whether any taxable income will result. Hence, no one could say at the end of any one of the earlier years of the enterprise whether any expenses of that year have contributed to the production of income and the taxpayer could not deduct such expenses, however much income they might eventually contribute to.

There is nothing in the language of the statute to justify or require any conclusion that only a person carrying on a non-business enterprise for the production of income out of the three classes of taxpayers covered by Section 23 (a) (1) and 23 (a) (2) may deduct only expenses necessary to or contributing to the production of income. The purpose of the statute was to eliminate differences between the rights of such taxpayers.

Under the Holding of the Court of Appeals Said Subdivision 23 (a) (2) Will Be Wholly Without Effect on an Individual Engaged in a Non-business Enterprise for the Production of Income. The Courts Interpret the Statute to Make Them Effective.

Even prior to the amendment of 1942, any taxpayer carrying on a non-business enterprise for the production of income could deduct from his gross income earned thereby any expenses necessarily incurred and paid in or contributing to the production of such income.

Referring to taxable income under Income Tax Statutes, the Circuit Court of Appeals of this Eighth Circuit has said that the meaning of the word "income" in the Sixteenth Amendment and in the Acts of Congress pursuant to that amendment "is that given to it in common speech and everyday usage."

Helvering v. Edison Bros. Stores, 133 Fed. (2d) 575.

The Circuit Court of Appeals of the Third Circuit has said:

> "The defined concept of income has been uniformly restricted to a gain realized, or a profit derived from capital or labor or both."
>
> *Keasbey & Mattison Co. v. Rothensis,* 133 Fed. (2d) 894.

See to the same effect *Bowers v. Kerbaugh Empire Co.,* 271 U. S. 170, 7 L. Ed. 886.

It having been always the purpose of the Congress to tax net income only, it is clear that even without the provisions of Section 23 (a) (2) any taxpayer engaged in a non-business enterprise could deduct from his receipts all items of expenses which actually contributed to such receipts. It is only after making such deductions that net income subject to taxation is obtained.

To tax gross income without deducting expenses which contributed to the production of it would be as unconstitutional and as foreign to the purpose and intent of the Congress as to tax receipts for property sold without first deducting the cost thereof.

When the Congress enacted Section 23 (a) (2) it intended the same to have some effect as to both classes of taxpayers therein referred to; and courts construe statutes, if reasonably possible, so as to make all parts effective.

Assignment No. 3.

The Court of Appeals Erred in Holding That the Expenses Incurred and Paid by Mr. Josephs Were Not Ordinary and Necessary Expenses of an Administrator of an Estate Within the Meaning of Sec. 23 (a) (2).

The Court of Appeals said it is impossible to believe that the expenses of respondent Josephs were such as ordinarily and necessarily result from the activities of a fiduciary. In this connection the Court said that the facts in this case are not distinguishable from the facts in the Heide case, supra. We cannot agree in this statement. In the Heide case Mr. Heide and three other trustees were sued for malfeasance in the management of four trust estates. The case was referred to a referee who proceeded to hear testimony. Before the hearings were completed the parties settled the case. Pursuant to such settlement, each of the trustees *paid into the trust estate* the sum of $3,000. Each of them waived their compensation and resigned. The Court approved the settlement on the report of the referee, who reported that not having heard all the testimony, he was unable to decide whether the trustees had been negligent to the extent of making themselves liable. The trustees undertook to secure deductions from their gross income of the $3,000 which each of them had paid in to the trust estates, and expenses incurred in connection with the litigation. The Court held that the trustees had been negligent in the performance of their duties. The theory of the Court seemed to be that the trustees "restored" $3,000 each to the trust estates, and that that "restoration" raised an implication of negligence or other malfeasance. The Court said of and concerning the Trustees:

> "Delinquent they are; for although they undertook no more than reasonable care in the circumstances, by hypothesis they have failed even in that."

The Court further continued with reference to said Subdivision 23 (a) (2):

> "The purpose of the provision which applies to all sorts of income is apparent; without it a person receiving income would be charged with his gross receipts and would not be allowed to set off the expenses without which these receipts would not have come to hand at all. That was an injustice comparable with charging the amount realized upon a capital gain and refusing to credit the basis. But the expenses so deducted should not be within the power of the taxpayer to avoid. They should result from conditions which stand in the path of his producing the income at all. They should not be such as he interposes himself, *as little so when his attention has flagged as when he has been deliberately unfaithful to his trust.*"

In this Josephs case the facts are very different. While the Government published, in connection with its petition to the Circuit Court of Appeals for a review of the decision of The Tax Court, voluminous and repetitious charges of malfeasance on the part of the taxpayer, nevertheless there has been no finding, adjudication or admission of any malfeasance whatsoever. It is elementary that an officer or trustee is presumed to have properly performed his duties until that presumption is overcome by evidence to the contrary. Regardless of any trust or official position, no one will be presumed guilty of either wilful or passive negligence or fraud until it is proven against him.

It will be noted further, as we have emphasized, that Mr. Josephs did not restore anything to the Freimuth Estate. He simply bought his way out as stated in the dissenting opinion in the court below, by payment to those individual heirs who were behind all of the litigation. The findings of The Tax Court do not cover this point. No request was made that they should. It is difficult to anticipate in the early stages of litigation just

what questions will arise. However, the record shows, beginning on page 45 at folio 58, the entire contract of settlement, the receipt in escrow of the $15,000 by the petitioner's attorney, and the instructions of the administrators as to the disposition to be made of it. The agreement as entered into and carried out simply ended the litigation, as pointed out in said dissenting opinion, and gave rise to no justifiable conclusions that there was either wilful or passive negligence on the part of the petitioner.

It will be noted that there was no charge of corruption against Mr. Josephs; that, as found by The Tax Court (R. 15, f. 18), a sweeping charge was made against the co-administrator, David Freimuth, that he, personally, "assumed exclusive control of the entire estate for his personal gain and advantage without regard to the rights of the co-administrators and contrary to the laws of the state of Minnesota, but to the contrary treated said administration and said assets as his individual property."

From the findings (R. 14, f. 17) it appears that Mr. Josephs did not at first consider that he was particularly involved when some of the heirs filed their complaint in the Probate Court. As found by The Tax Court he stated "that if it would accomplish or contribute anything to a settlement of the controversy which was arising between the heirs in closing the estate he was glad to forego any fees or expenses" (R. 14, f. 17).

While the facts in the Heide case were very different than they are here, nevertheless, we wish to direct attention to many cases which do not seem to harmonize with that Heide case.

There is reason for holding that any trustee guilty of wilful malfeasance in office may not deduct from his income any amount restored to the estate as a result of such misconduct, or deduct any expenses which would not have arisen except for such misconduct, nevertheless, it has long been settled law that within the meaning of

Section 23 (2) (1) relating to carrying on a business, the words "ordinary and necessary expenses" do include the expense of conducting and compromising litigation. *Kornhauser v. United States,* 320 U. S. 467; *Welch v. Helvering,* 290 U. S. 111; *Commissioner v. Heininger,* 320 U. S. 467; *Hochschild v. Commissioner,* 161 Fed. (2d) 817.

Further, and more specifically, it is held that the sum paid in satisfaction of a judgment for damages for negligence in carrying on a business is deductible, *Anderson v. Commissioner,* 81 Fed. (2d) 457; that the amount paid in satisfaction of a judgment for fraud is deductible, *Helvering v. Hampton,* 79 Fed. (2d) 356; and that an amount paid in compromise of litigation for alleged misrepresentation is deductible. *Howard v. Commissioner,* 22 B. T. A. 375.

Even the Heide case was not a case calling for the denial of the deductions claimed because of any reason of public policy which prevents the taxpayer from deducting the amount of any penalty paid as a punishment for crime. *Commissioner v. Heininger,* supra; *Commissioner v. Longhorn Portland Cement Co.,* 148 Fed. (2d) 276; *Helvering v. Hampton,* supra.

Clearly, we submit, and without regard to the essential differences between the Heide case and this Thomas case, the decision of the *Commissioner v. Heininger,* supra, firmly establishes the rights of Mr. Josephs to his claimed deductions. That case is very important to the determination of this one. The opinion is not too lengthy, and we therefore refrain from undertaking any long quotations therefrom or short quotations which might be inadequate or misleading. Under any permissible construction of the facts in this case, the deductions here claimed would be allowable under that Heininger case.

The Words "All the Ordinary and Necessary Expenses Paid or Incurred" Must Be Given the Same Meaning in Subdivision 23 (a) (2) as in Subdivision 23 (a) (1).

Prior to the amendment of 1942, the words "all the ordinary and necessary expenses" as contained in section 23 (a) (1) had acquired a clear and definite meaning as applied to litigation expenses, to-wit:

> "Expenses directly connected with or as otherwise stated proximately resulting from the business (Kornhauser v. United States, supra)."

~~Quote from senate report, p. 19.~~

The word "ordinary" does not mean habitual. A suit affecting even the safety of a business may happen once in a lifetime, none the less the cost of defending it is an ordinary one because that is the common and accepted means of defending an attack.

Welch v. Helvering, 290 U. S. 311;
Helvering v. Hampton, supra.

The same description of expense is contained in subdivision (a) (2) and this Court has already said in the Bingham's Trust case that they mean the same as they mean in subdivision (a) (1) when applied to a taxpayer maintaining property held for the production of income.

But under the Circuit Court of Appeals' decision the definition is limited to expenses incurred in removing obstacles to the production of any income at all. We respectfully submit that there is no justification for that narrowing of the meaning of the words. It is a familiar rule that when the language of a statute has acquired a definite meaning, then that same language when used subsequently in the statute will be interpreted to mean the same thing. Words used in a statute are to be given a uniform construction whenever possible.

School District v. School District, 151 Minn. 52.

Assignment No. 4.

The Circuit Court of Appeals Erred in Reversing The Tax Court on Questions Which Are Not Reviewable.

In our brief before the Circuit Court of Appeals we agreed with the Commissioner's argument that there was involved in this case clear questions of law and that the decision of The Tax Court was reviewable.

In the light of Judge Sanborn's dissenting opinion in the Court of Appeals, and especially the last paragraph thereof we now believe we were wrong.

The case of *Dobson v. Commissioner,* 320 U. S. 489, is cited most commonly to sustain the proposition that a finding of The Tax Court is conclusive on a question of fact if there is evidence tending to support it. The Dobson case goes further than that. As already argued, it is to the effect that it is for The Tax Court alone to determine whether an apparently integrated transaction shall be broken up into several steps, or whether what apparently are several steps shall be synthesized into one whole transaction. It is also to the effect that the decisions of The Tax Court on such questions are not reviewable.

We desire to quote from that decision:

> "Congress has invested The Tax Court with primary authority for redetermining deficiencies, which constitutes the greater part of tax litigation. This requires it to consider both law and facts. Whatever latitude exists in resolving questions such as those of proper accounting, *treating a series* of transactions as *one* for tax purposes, or treating *apparently separate ones as single* in their tax consequences; exists in The Tax Court and *not in the regular courts;* when the court cannot separate the elements of a decision so as to identify a clear-cut mistake of law, the decision of The Tax Court must stand. In view of the division of functions between The Tax Court and reviewing courts it is of course

the duty of The Tax Court to distinguish with clarity between what it finds as fact and what conclusion it reaches on the law. In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter. The Tax Court is informed by experience and kept current with tax evolution and needs by the volume and variety of its work. While its decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible.

"The Government says that 'the principal question in this case turns on the application of the settled principle that the single year is the unit of taxation.' But The Tax Court was aware of this principle and in no way denied it. Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, The Tax Court's selection of the course to follow is no more reviewable than any other question of fact."

Under the rulings of this Dobson case, we respectfully submit that the determination of The Tax Court that the enterprise which Mr. Josephs conducted for the production of income should be treated as a whole, and that any expenses reasonably connected with or arising out of the carrying on of that enterprise are deductible, is conclusive.

It is also our contention that under the doctrine of the Dobson case, as pointed out by Judge Sanborn's dissenting opinion, the decision of The Tax Court that the expenses in question were of a character which could properly be deducted by a professional administrator, and therefore by a casual administrator, is binding and conclusive, there being nothing irrational or illogical in that

decision. The decision of the Circuit Court of Appeals should be reversed. All of which is respectfully submitted.

FLOYD F. TOOMEY,
1200 18th Street N. W.,
Washington 6, D. C.,
Attorney for Petitioner.

H. A. DANCER,
1000 Alworth Building,
Duluth, Minnesota,
Of Counsel.

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 346

ESTATE OF HYMAN Y. JOSEPHS, DECEASED, ARTHUR C. JOSEPHS, EXECUTOR, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 11-25) is reported in 8 T. C. 583. The opinions of the Court of Appeals (R. 70-80) are reported in 168 F. 2d 233.

JURISDICTION

The judgment of the Court of Appeals was entered on May 20, 1948. (R. 80.) On August 17, 1948, Mr. Justice Jackson extended the time for

filing a petition for a writ of certiorari to October 19, 1948. (R. 83.) The petition for a writ of certiorari was filed on October 11, 1948.[1] The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

Whether the sums paid by the taxpayer in settlement of suits charging him as administrator with mismanagement of an estate and as attorney's fees in that litigation, are deductible expenses within the meaning of Section 23 (a) (2) of the Internal Revenue Code, as amended.[2]

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Section 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

* * * *

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[1] The taxpayer filed an earlier petition (No. 225) on August 16, 1948, which was dismissed by order of this Court on October 18, 1948, on motion of counsel for the petitioner. The reason for the dismissal was that the taxpayer died after his petition was filed. His executor filed the present petition on October 11, 1948.

[2] In the Tax Court the taxpayer maintained, in the alternative, that he was entitled to the deduction under Section 23 (a) (1) of the Internal Revenue Code, as amended. The Tax Court found it unnecessary to pass upon the question, but the court below remanded the case to the Tax Court to determine whether the taxpayer was in fact carrying on a trade or business while acting as administrator, within the meaning of Section 23 (a) (1). (R. 77.)

(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

* * * *

(26 U.S.C. 1946 ed., sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:[3]

SEC. 19.23(a)-15 [as added by T. D. 5196, 1942-2 Cum. Bull. 96]. *Nontrade or Nonbusiness Expenses.—(a) In General.*—Subject to the qualifications and limitations in Chapter 1 and particularly in section 24, as amended, an expense may be deducted under section 23 (a) (2) only upon condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

* * * *

[3] While Section 19.23(a)-15 of Treasury Regulations 103 was subsequently amended, the amendments do not affect the provisions quoted above.

STATEMENT

The facts as found by the Tax Court (R. 12-16) may be summarized as follows:

In May, 1930, the taxpayer and two others were appointed administrators of the estate of Ignatz Freimuth, deceased. (R. 13.) The estate consisted chiefly of a retail department store in Duluth, Minnesota, and also included real estate, stocks, bonds, and cash. (R. 12.) Shortly after their appointment, the administrators formed a Delaware corporation to which they transferred the estate's assets in exchange for the capital stock of the corporation. (R. 13.) The taxpayer served as a director of the Delaware corporation for about three and one-half years and until the administrators formed a Minnesota corporation, to which the assets of the Delaware corporation were transferred. The common stock of the Minnesota corporation was issued to the administrators, but the taxpayer was neither a director nor officer of this corporation. Details of the operation of the Minnesota corporation were left to one of the taxpayer's co-administrators, David Freimuth, a son of Ignatz Freimuth. The taxpayer was frequently consulted on financial matters concerning the store and was often consulted by the heirs with respect to the estate affairs. (R. 13-14.)

In December, 1939, some of the heirs of Ignatz Freimuth filed a petition in the State Probate Court objecting to the manner in which the estate

was being administered and asking for an accounting and other relief. At that time the taxpayer advised the attorney retained to close the administration of the estate that he would forego compensation as administrator if his waiver would aid in the settlement of the controversy with the heirs. (R. 14.)

In March, 1940, the taxpayer and his co-administrator filed an accounting of their administration in the State Probate Court.[4] Some of the heirs filed objections to the accounting, charging misconduct and waste on the part of the administrators. In August, 1940, the administrators filed a final accounting of their administration in the State Probate Court. The heirs who had objected to the previous accounting renewed their charges of misconduct and waste. The final accounting of the administrators was approved by the Probate Court. (R. 14-15.) The dissatisfied heirs appealed to the State District Court. (R. 16.)

In February, 1941, the heirs commenced an independent action in the State District Court against the administrators, the corporation, and others charging mismanagement of the estate by the administrators and praying for damages. The defendant administrators' demurrer to the complaint in this action was sustained. The heirs appealed to the Supreme Court of Minnesota. (R. 16.)

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[4] The third administrator died pending the administration, and a successor was never appointed. (R. 13.)

In 1941, while both appeals were pending, the parties to the litigation reached an agreement for settlement. The pending appeals were dismissed; the final accounting of the administrators approved; and the taxpayer paid $10,000 for full release from all liability asserted against him in the suits brought by the heirs, and, in connection with the litigation, paid attorneys' fees of $1,500. (R. 16.)

The Tax Court, with three judges dissenting (R. 19-25), decided that the taxpayer was entitled to the deduction of the sums in question on the ground that Section 23 (a) (2) of the Internal Revenue Code, as amended, permits the deduction of expenditures which are directly connected with or proximately result from an income-producing activity or from an activity consisting of the management of income-producing property. The Tax Court did not reach the question whether the taxpayer was entitled to the deduction under Section 23 (a)(1) of the Internal Revenue Code. (R. 16-19.)

The Commissioner appealed to the Court of Appeals for the Eighth Circuit, which, with Judge Sanborn dissenting, reversed the decision of the Tax Court on the ground that it was not enough that an expense be paid or incurred in connection with an income-producing activity in order to fall within the first class of deductions allowed by Section 23 (a) (1), but the expense must be neces-

sary to and paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. (R. 76.) The court below remanded the case to the Tax Court to determine whether the taxpayer was engaged in carrying on a trade or business while acting as administrator, within the meaning of Section 23 (a)(1). (R. 77.)

ARGUMENT

1. The decision of the court below is correct. The Tax Court construed Section 23 (a)(2) of the Internal Revenue Code, as amended, *supra,* to mean that if an expenditure was directly connected with the taxpayer's services as administrator of an estate it was deductible, and held that since the sums in question were paid in settlement of a suit for mismanagement of the estate and for attorney's fees in that litigation, they were connected with his services as administrator and were therefore deductible within the meaning of the statute. The flaw in this holding is that these expenses resulted from the mismanagement, not from the management, of the estate; they were avoidable and therefore not necessary to either the production of income or to the management of property held for the production of income within the meaning of the statute. There is no reason to believe that Congress intended to permit deductions which would have the effect of subsidizing fiduciaries who violate their trust obligations. See *Commissioner* v.

Heide, 165 F. 2d 699, 701 (C.C.A. 2d). That the taxpayer was negligent in his duties as fiduciary is indicated by the substantial amount paid in settlement in addition to the fact that he waived commissions over a period of ten years (the Tax Court having found that he expected to be paid for his services (R. 16)). See *Commissioner* v. *Heide, supra.*

The court below followed the construction of Section 23 (a) (2) laid down by this Court in *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, 374, that in order to come within the statute the expenditures must be either ordinary and necessary expenses paid or incurred for the production of income, or ordinary and necessary expenses paid for the management, conservation or maintenance of property held for the production of income. Section 19.23 *(a)*-15 of Treasury Regulations 103, *supra,* adopts the same interpretation of the statute, and it is significant that this Court did not question the correctness of this part of the Regulations in *Trust of Bingham* v. *Commissioner,* although it did hold (p. 377) that another provision in the regulation was invalid. Since it cannot be said that the mismanagement of the estate was necessary for the production of income or for the management of the property, the court below correctly held that the taxpayer was not entitled to the deduction. *Commissioner* v. *Heide, supra.*

2. There is no conflict of decisions. The only other court decision in a similar case since the enactment of Section 23 (a)(2) is *Commissioner* v. *Heide, supra,* and that case is in accord with the decision of the court below. In that case the taxpayer was one of four trustees under four trusts created by his father; remaindermen and beneficiaries filed objections to the trustees' accounts, alleging that in some instances securities had improvidently and negligently been exchanged, or had negligently been held after depreciation and default. The court referred the issue to a referee, who held hearings, but before whom the parties eventually settled their controversies by a stipulation which the court approved, under which the trustees were to resign, to abandon any claims for commissions, and to pay $3,000 to the corpus of each trust. Accompanying this stipulation, the referee filed an opinion, in which he declared that on the evidence he was unable to decide whether or not the trustees had been negligent in the sense that they had made themselves personally liable. The taxpayer sought to deduct the $3,000 under Section 23 (a)(2), which the Tax Court permitted him to do; the Second Circuit reversed the Tax Court on the ground that since the taxpayer could have avoided the expenditure, it was not necessary within the meaning of the statute. The court below held that the facts in the *Heide* case are not dis-

tinguishable from the facts here (R. 76), and followed the decision of the Second Circuit.

It may be noted that Judge Sanborn in the court below based his dissenting opinion on the fact that in the present case the Tax Court made no finding that the taxpayer mismanaged the trust estate. (R. 78.) But neither did the Tax Court make such a finding in the *Heide* case. *Heide* v. *Commissioner,* 8 T. C. 314. The circumstances of the settlement of the litigation in the *Heide* case did not differ in any material respect from the settlement in this case.

The taxpayer argues that the decision of the court below is in conflict with the decisions of this Court in *Trust of Bingham* v. *Commissioner, supra; Commissioner* v. *Heininger,* 320 U. S. 467; and *Dobson* v. *Commissioner,* 320 U. S. 489. (Pet. 6.) All of these cases involve substantially different facts. In the *Bingham* case the taxpayer was a trust, and the expenses in question were counsel fees for contesting tax deficiencies, and for legal advice in connection with the payment of one of the cash legacies and with other problems arising upon the expiration of the trust and relating to the final distribution of the trust fund among the residuary legatees. The Government did not question these expenses on the ground that they were not necessary within the meaning of Section 23 (a) (2), but only on the ground that they were not paid for the production of income. In the instant case the ex-

penditures did not relate to the routine duties of a fiduciary as they did in the *Bingham* case, but they arose out of the neglect or mismanagement on the part of the taxpayer.

In the *Heininger* case the taxpayer had for twelve years been selling false teeth through the mails; in 1938 he was charged with fraudulent use of the mails, which resulted in the issuance of an order by the Postmaster General that money orders to the taxpayer should not be paid and letters addressed to him should be returned marked "fraudulent". Since this would have destroyed the taxpayer's business, he sought an injunction against the order, which was granted by the District Court, but dissolved by the Circuit Court of Appeals, and certiorari was denied by this Court. All of this cost the taxpayer $36,600 in attorney's fees and legal expense, for which he took a deduction in his 1938 return. The Commissioner denied the deduction. This Court held that the taxpayer was entitled to the deduction on the ground that it was an ordinary and necessary expense of taxpayer's business under the circumstances of that case. That case is obviously quite different from the instant case.

The *Dobson* case involved the question of whether the taxpayer realized income through the recovery of sums previously deducted as losses, which is entirely different from the instant case. With respect to the rule of the scope of review laid down

in that case,[5] it is not applicable here because this case involves a question of statutory construction. See *Trust of Bingham* v. *Commissioner, supra; Commissioner* v. *Heininger, supra; Commissioner* v. *Heide, supra.* It may be noted that in the court below both parties concurred that the decision of the Tax Court was reviewable. (R. 72.)

CONCLUSION

The decision of the court below is correct, and there is no conflict of decisions. The petition for a writ of certiorari should be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
MORTON K. ROTHSCHILD,
Special Assistants to the Attorney General.

NOVEMBER, 1948.

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[5] The rule as to the scope of review laid down in the *Dobson* case was repealed by Section 36 of the Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess., which became effective September 1, 1948. S. Rep. No. 1559, 80th Cong., 2d Sess., p. 13.

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